IN THE

Supreme Court of the United States

OCTOBER TERM 1941

No. 757

PRUDENCE REALIZATION CORPORATION,
Petitioner,

against

A. JOSEPH GEIST, Trustee.

ON WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SECOND CIRCUIT

BRIEF ON BEHALF OF PETITIONER, PRUDENCE REALIZATION CORPORATION

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Opinions Below

Written opinions have been rendered by the District Court (R. 123-125, not yet reported) and by the Circuit Court of Appeals for the Second Circuit, reported at 122 F. (2d) 503 (R. 129-145).

Jurisdiction

The decree of the Circuit Court of Appeals was entered on August 29, 1941 (R. 146). The petition for a writ of certiorari to the United States Circuit Court of Appeals for the Second Circuit was granted by this Court on January 5, 1942. The jurisdiction of this Court is invoked under Section 240a of the Judicial Code, as amended by the Act of February 13, 1925 (28 U. S. C. A., Sec. 347-a).

Questions Presented

Must the guaranteed mortgage certificates held by petitioner (a creditors corporation formed to liquidate the assets of the guarantor pursuant to a reorganization under the Bankruptcy Act) be subordinated as to time of payment to certificates held by others? The majority of the Circuit Court of Appeals held the decisions of the New York Court of Appeals controlling on the issues presented on this appeal and accordingly answered in the affirmative. The Court also held that, despite the fact that preferences unauthorized by the Bankruptcy Act would result, the New York rule of distribution should be applied here so that creditors of all insolvent New York mortgage guarantee companies should receive similar treatment without regard to the tribunal in which the proceeding for the liquidation of any such guarantor took place.

The principal questions involved are:

(1) Was the Circuit Court of Appeals, under the decision of this Court in *Erie R. Co.* v. *Tompkins*, 304 U. S. 64, 58 Sup. Ct. 817, 82 L. Ed. 1188, obliged to follow the decisions of the New York Court of Appeals even though the adoption of the rule of distribution established by such decisions results in restricting the equitable power of the bankruptcy court to classify claims of creditors of the guarantor for purposes of distribution under the Bankruptcy Act?

(2) Did the Circuit Court of Appeals, in following the state court decisions, improperly impose a restriction upon the equitable and statutory powers of the bankruptcy court to classify creditors' claims?

(3) Did the Circuit Court of Appeals properly impose upon the remaining unsecured creditors of an insolvent guarantor the burden of showing that the granting of priority to other unsecured creditors of the same insolvent would be inequitable?

(4) Was the Circuit Court of Appeals justified in granting preferential rights to certain creditors of the insolvent guarantor, after the confirmation of a creditors' plan of reorganization for the guarantor-debtor under Section 77B of the National Bankruptcy Act, where such plan did not provide for such preference and where such creditors were not separately classified?

Statement

Prudence Realization Corporation, petitioner here, is a creditors corporation organized as a result of the reorganization of The Prudence Company, Inc., under Section 77B of the Bankruptcy Act (R. 8, 9). The Prudence Company, Inc., hereafter called "Prudence", was organized under the Banking Law of the State of New York in 1919. It was engaged in the business of making loans secured by mortgages on real estate. The bonds and mortgages received for such loans were assigned to an affiliated corporation, Prudence-Bonds Corporation, the stock of which was owned by New York Investors, Inc., which also owned all of the common stock of Prudence (R. 16). Prudence-Bonds Corporation transferred these bonds and mortgages to corporate trust companies, called depositaries, and issued certificates of participation in such mortgages to Prudence, which in turn sold them to the general public together with its guaranty of payment of principal and interest (R. 16, 17). These mortgage participation certificates constituted the holders thereof tenants in common of the underlying mortgage and bond secured thereby. *In re Westover* (C. C. A. 2d), 82 F. (2nd) 177.

In the course of its business, from time to time Prudence either repurchased some of these certificates from the investing public, or received them in exchange for certificates in other mortgages. The certificates on hand, either prior to sale to the public or upon reacquisition, were included in the corporate assets of Prudence as evidenced by pub-

lished financial statements and corporate balance sheets prepared by certified public accountants (R. 18). It was the intention of Prudence in each instance, upon the acquisition of the aforementioned certificates, to hold them as investments, and not in cancellation or payment of its guarantee obligation (R. 18).

The Zo-Gale Certificate Issue, involved in this appeal, was created in the manner above described. The mortgage, originally in the principal amount of $480,000, was reduced by payment by the mortgagor to $390,000. Certificates to the extent of $382,800 are now outstanding. Included in the assets of the insolvent Prudence estate transferred to petitioner are $816.67 in principal amount of Zo-Gale certificates which were repurchased by Prudence in 1932 for full value (R. 17, 18). The remaining $7,200 interest in the mortgage, against which no certificates were issued, is now also held by petitioner, and was acquired by the Prudence Trustees from the Prudence-Bonds Corporation Trustees, subject, however, to the claims of general creditors of Prudence-Bonds Corporation (R. 20, 21).

In January, 1935, an involuntary petition for the reorganization of Prudence under Section 77B of the Bankruptcy Act was filed in the Eastern District Court and on February 1, 1935, the petition, consolidated with the debtor's voluntary petition for reorganization, was approved and trustees appointed. An order was entered in that proceeding prescribing the procedure for the filing of proofs of claim by creditors, including certificate holders of the Zo-Gale Issue, who were unsecured creditors of the debtor by reason of its guaranty of the Zo-Gale certificates (R. 19). In these proofs of claim, all certificate holders asserted unsecured claims for the full principal and interest due on the Prudence guaranty of the certificates held by them (R. 30-32), and they were allowed as such.

Prudence Realization Corporation, the petitioner here, was organized pursuant to a plan of reorganization for Prudence under Section 77B of the Bankruptcy Act (R. 8, 9). The plan was proposed by Reconstruction Finance

Corporation, the largest single creditor of Prudence, after a finding had been made that Prudence was insolvent. The plan provides that the stockholders of Prudence have no interest in the liquidation of its assets, and provides for the distribution of the proceeds of such liquidation to creditors only (R. 73). Petitioner is therefore solely a creditors' realization corporation and in no way represents interests of the old stockholders.

On March 16, 1936, pursuant to authorization secured in the Prudence proceeding, the petition for reorganization of Amalgamated Properties, Inc., as a subsidiary of Prudence, was approved by the Eastern District Court (R. 21). Included among its assets was the real property upon which the Zo-Gale Certificate Issue mortgage was a lien. The property had been purchased by Amalgamated on February 1, 1933, subject to the outstanding certificated mortgage (R. 21). In the Amalgamated proceeding a plan of reorganization for the Zo-Gale Certificate Issue was proposed which provided for the transfer of the real property by Amalgamated to a Trustee, appointed for Zo-Gale certificate holders, who also pursuant to said plan acquired the certificated mortgage. The lien of the mortgage was preserved for the benefit of all such certificate holders, who also became co-owners of the real estate. That plan of reorganization for the Zo-Gale Issue, as amended, was finally approved by the District Court on February 19, 1938, and the property, together with the entire outstanding mortgage, was transferred to A. Joseph Geist, Trustee, respondent herein (R. 5, 7, 8).

The order confirming the Zo-Gale plan, entered in that proceeding, provides that the rights of the certificates owned by Prudence to parity with those held by the other certificate holders is reserved for future judicial determination (R. 6). This provision also related to the uncertificated interest or share for which the Trustee by such order was directed to deliver a certificate to the Trustees of Prudence-Bonds Corporation (R. 7).

Throughout the proceedings above described, from February 1, 1935, Prudence was in reorganization and in 1938 a creditors' plan of reorganization for Prudence was proposed by Reconstruction Finance Corporation, its most substantial creditor. Copies of that plan of reorganization were forwarded to every holder of a guaranty claim as well as to other creditors of Prudence. Included among the guaranty claimants were the certificate holders in the Zo-Gale Issue. Throughout the period of consideration of the plan of reorganization, no claim was ever asserted in the Prudence proceeding on behalf of any Zo-Gale certificate holders to priority in distribution, nor was any claim made in that proceeding that by reason of the default by Prudence on its guaranty of the Zo-Gale certificate, the certificates held by Prudence in this issue were to be deemed subordinate to those held by other certificate holders (R. 20). *The order confirming the plan determines that there are no claims having priority except tax claims and claims for administration expenses* (R. 107). The plan of reorganization for Prudence was approved by the District Court on May 26, 1939, *fifteen months after the Zo-Gale plan was confirmed by the same judge* (R. 22).

In accordance with the provisions of the plan for Prudence, by assignment dated June 1, 1939, all of the assets of Prudence and its Trustees were transferred and assigned over to petitioner for the purpose of liquidation and distribution of the proceeds to Prudence creditors. Included in those assets were the certificates and uncertificated interest in the Zo-Gale Certificate Issue (R. 9). As is set forth in the order confirming the Prudence Plan, there are outstanding obligations of Prudence aggregating $134,123,298.95 (R. 102). Of these claims only the claim of the United States of America for $400,000 has been fully paid.

Prior to the institution of the proceedings for the reorganization of Prudence, and in 1932, all of the stock of Amalgamated Properties, Inc., had been deposited as part of the collateral for a loan made by Reconstruction Finance Corporation to Prudence. In 1938, in accordance with a

decision of the Circuit Court of Appeals for the Second Circuit (*In re The Prudence Company, Inc.*, [C. C. A. 2d] 90 F. [2d] 587), the control and complete ownership of that subsidiary of Prudence passed to Reconstruction Finance Corporation.

Prudence-Bonds Corporation was found insolvent in March, 1937, and the plan of reorganization confirmed transferred all of its assets to a new corporation for the benefit of its secured creditors. *In re Prudence-Bonds Corporation,* (C. C. A. 2d) 122 F. (2d) 258, 261.

The instant proceeding was instituted in the Zo-Gale reorganization proceeding by A. Joseph Geist, as trustee of the reorganized Zo-Gale mortgage and underlying real property. The relief sought is an order determining that the certificates and uncertificated share, now held by petitioner, the creditors' realization corporation, are subordinate to those held by others and that no payments of either principal or interest shall be made on such certificates or share until the other certificate holders receive in full the principal and interest which had been guaranteed by Prudence (R. 9).

Petitioner, as representative of all of the Prudence creditors, urged that the issue presented should be determined solely in accordance with the Bankruptcy Act, and that under that Act the granting of the relief sought would result in an unauthorized preference in favor of Zo-Gale guaranty creditors as against the remaining creditors of Prudence, the insolvent guarantor (R. 24-26). The District Court, however, deemed the decisions of the New York Court of Appeals on the parity question controlling, and without considering the merits of the controversy, granted the application in all respects. The order entered upon such decision determines, first, that the certificates and share in this issue held by Prudence Realization Corporation for the benefit of all of the Prudence creditors are subordinate to those of the other certificate holders, and second, that no payment shall be made upon such certificates or share to Prudence Realization Corporation

"until the third party certificate holders have been paid in full the principal and interest guaranteed under the certificates held by such third party certificate holders" (R. 126).

The United States Circuit Court of Appeals for the Second Circuit on August 11, 1941, handed down its opinion affirming the decision of the District Court. The affirmance was by a divided court, the majority opinion being written by Circuit Judge Charles E. Clark and concurred in by Circuit Judge Thomas W. Swan and the dissenting opinion being written by Circuit Judge Jerome N. Frank (R. 57-73).

The majority believed the decisions of the New York Court of Appeals on the question of parity to be controlling under the decision of this Court in *Erie R. Co.* v. *Tompkins*, 304 U. S. 64, 58 Sup. Ct. 817, 82 L. Ed. 1188, 114 A. L. R. 1487.

Although the question arises as a controversy in the Zo-Gale reorganization proceeding as to the payment of the proceeds of the mortgage, in substance the issue relates to the distribution of the assets of the bankrupt guarantor (pp. 13 ff. and 28 ff., *infra*).

Specification of Errors

The court below erred,

(1) in holding that the decisions of the New York court determining questions of distribution of an insolvent mortgage guaranty company's assets under state statutes are binding upon the bankruptcy court under the authority of *Erie R. Co.* v. *Tompkins*, 304 U. S. 64, 58 Sup. Ct. 817, 82 L. Ed. 1188;

(2) in failing to hold that, in accordance with the provisions of the Bankruptcy Act, Prudence Realization Corporation is entitled to share equally with other certificate holders in the proceeds of the Zo-Gale Mortgage Certificate Issue;

(3) in holding that the certificates of participation in the Zo-Gale Certificate Issue owned by Prudence

Realization Corporation are not entitled to parity of distribution with other certificates held by the general public, but are subordinate to the certificates held by others;

(4) in holding that Prudence Realization Corporation as owner of the uncertificated interest acquired from Prudence-Bonds Corporation in the Zo-Gale mortgage is not entitled to parity of distribution with the other holders of certificates, but is subordinate to such other holders;

(5) in failing to hold that, by the failure of the other holders of Zo-Gale certificates to file claims for priority in the Prudence proceeding or require provision for priority in their favor in the plan of reorganization for Prudence, such holders have waived their rights and may participate only as general creditors without priority or preference as against any other creditors of Prudence.

Summary of Argument

POINT I—THE DECISION OF THIS COURT IN ERIE R. CO. V. TOMPKINS DOES NOT REQUIRE THE FEDERAL BANKRUPTCY COURT TO FOLLOW STATE COURT DECISIONS ESTABLISHING RULES OF INSOLVENCY DISTRIBUTION (p. 10).

POINT II—WHERE RULES OF INSOLVENCY DISTRIBUTION PRESCRIBED BY THE BANKRUPTCY ACT AND STATE DECISIONS ARE IN CONFLICT, THE BANKRUPTCY ACT IS PARAMOUNT AND MUST BE APPLIED BY THE BANKRUPTCY COURT (p. 21).

POINT III—UPON EQUITABLE GROUNDS PETITIONER'S CERTIFICATES ARE ENTITLED TO PARITY OF DISTRIBUTION (p. 24).

POINT IV—THE PLAN OF REORGANIZATION FOR THE INSOLVENT GUARANTOR DID NOT SEPARATELY CLASSIFY ZO-GALE GUARANTY CREDITORS AND BARS RESPONDENT'S CLAIM FOR PRIORITY (p. 27).

POINT I

The decision of this Court in *Erie R. Co.* v. *Tompkins* does not require the federal bankruptcy court to follow state court decisions establishing rules of insolvency distribution.

The Zo-Gale certificate owners as holders of guaranty claims are included in the interests represented by petitioner, and they participate in the proceeds of the liquidation of the assets of the Prudence estate on a parity with all other creditors. The main issue on this appeal, therefore, is whether the Zo-Gale certificate holders, in addition to sharing pro rata with other unsecured Prudence guaranty creditors in the other assets of the insolvent estate, are entitled to a priority claim against such portion of the assets as are represented by Zo-Gale certificates held in the name of petitioner. If parity is accorded petitioner's participating interests in the Zo-Gale issue, the Zo-Gale certificate holders will receive only their pro rata share of the proceeds of the certificates. However, if the decision of the Circuit Court stands, they will receive the entire proceeds of the certificates, and remaining guaranty creditors will be barred from any interest in such asset until the full amount of principal and interest guaranteed by Prudence has been received by the Zo-Gale certificate holders.

Independently of consideration of the merits of the controversy between the parties to this appeal, the majority of the Circuit Court of Appeals believed itself bound to follow the decisions of the New York courts on the parity question because of this Court's decision in *Erie R. Co.* v. *Tompkins*,

304 U. S. 64, 58 Sup. Ct. 817, 82 L. Ed. 1188. As a basis for reaching that conclusion, the majority found that the rule established by the New York decisions rested upon the interpretation of the contract of guaranty and the certificates as constituting an agreement that the certificates repurchased by the guarantor were to be subordinate in time of payment to the certificates held by others. The Court recognized, however, that if the local decisions established a rule of insolvency distribution, the federal court in administering a bankrupt estate was free to apply its own rules of distribution, and *Erie R. Co.* v. *Tompkins, supra,* did not apply.

It is submitted that the decision in *Erie R. Co.* v. *Tompkins, supra,* establishes no more than that, in cases arising in the federal court by reason of diversity of citizenship between the parties to the litigation, the federal court may not apply its own general law but is required to apply the local law (1941) 51 Yale L. J. 315, 319; (1941) 55 Harv. L. Rev. 283, 284. The clarification made by that decision in the rule established in *Swift* v. *Tyson,* 16 Pet. 1, 10 L. Ed. 865, was to affirm the fact that there is no federal general common law, and that "except in matters governed by the Federal Constitution or by Acts of Congress, the law to be applied in any case is the law of the state" and that "whether the law of the state shall be declared by its Legislature in a statute or by its highest court in a decision is not a matter of federal concern." *Erie R. Co.* v. *Tompkins,* 304 U. S. at p. 78, 58 S. Ct. at p. 822.

There can be no implication from the opinion in that case that any abdication of clearly defined federal prerogative was intended. In *City of New York* v. *Feiring,* 313 U. S. 283, 61 S. Ct. 1028, 85 L. Ed. 1313, decided after *Erie R. Co.* v. *Tompkins, supra,* in determining whether the New York City Sales Tax was a tax within the meaning of §64 of the Bankruptcy Act, this Court said, 313 U. S. at p. 285, 61 S. Ct. at p. 1029:

> "Whether the present obligation is a 'tax' entitled to priority within the meaning of the statute is a federal

question. *New Jersey* v. *Anderson*, 203 U. S. 483, 491, 27 S. Ct. 137, 139, 51 L. Ed. 284; cf. *Burnet* v. *Harmel*, 287 U. S. 103, 110, 53 S. Ct. 74, 77, 77 L. Ed. 199; *Palmer* v. *Bender*, 287 U. S. 551, 555, 53 S. Ct. 225, 226, 77 L. Ed. 489; cf. *United States* v. *Pelzer*, 312 U. S. 399, 61 S. Ct. 659, 85 L. Ed. , decided March 3, 1941. Intended to be nationwide in its application, nothing in the language of §64 or its legislative history suggests that its incidence is to be controlled or varied by the particular characterization by local law of the state's demand. Hence we look to the terms and purposes of the Bankruptcy Act as establishing the criteria upon the basis of which the priority is to be allowed."

Similarly the courts of the State of New York have recognized the fact that the Bankruptcy Act and its construction by the federal courts control the state courts in determining questions arising under the Act. In *Brenen* v. *Dahlstrom Metallic Door Company*, 189 App. Div. 685, 178 N. Y. S. 846, the court said, 189 App. Div. at p. 688, 178 N. Y. S. at p. 848:

"The Bankruptcy Act having been passed by Congress pursuant to the power delegated to it by the Federal Constitution (Art. 1, §8, subd. 4) is the supreme law of the land. Its provisions are paramount to any State statute, and we have always recognized and followed the decisions of the Federal Court construing it dealing with questions arising under that Act, even if they are in conflict with our own decisions. (Cf. *Hyde Park Flint Bottle Co.* v. *Miller*, 179 App. Div. 73; *Manheim* v. *Loewe*, 185 id. 601, 607.)"

In this case, the New York decisions deemed controlling by the majority of the Circuit Court, were rendered in cases involving the liquidation of guaranteed mortgage companies in statutory proceedings (New York Insurance Law, Art. XVI), and the reorganization of the guaranteed securities pursuant to specific statutory authorization. ("Schackno Act," New York L. 1933, ch. 745; "Mortgage Commission Act", New York L. 1935, ch. 19.) In no instance was the guarantor a corporation whose assets were being or had been administered by the federal court under the Bankruptcy Act.

The New York decisions determine that, in cases arising under the state statutes above referred to, where certificates of participation have been repurchased by the guarantor, in the absence of very clear and unambiguous language showing a contrary intent, the court will not permit the guarantor to share in the proceeds of insufficient security until the holders of its guaranties shall have been paid in full. Where no evidence of intention appears, the courts imply an intention that the guarantor's holdings shall be subordinated. *In re Union Guarantee & Mortgage Co.*, 285 N. Y. 337, 34 N. E. (2d) 345; *Pink* v. *Thomas*, 282 N. Y. 10, 24 N. E. (2d) 724; *In re Title & Mortgage Guaranty Co. of Sullivan County*, 275 N. Y. 347, 9 N. E. (2d) 957, 115 A. L. R. 35; *Title Guarantee and Trust Company* v. *Mortgage Commission*, 273 N. Y. 415, 7 N. E. (2d) 841.

In the instant case, the certificate itself contains no language showing an intention to subordinate certificates held or repurchased by the guarantor. On the contrary, the certification made by the depositary, printed on the certificate, specifically states, "* * * that the interest of the holder in said bond and mortgage is not subordinate to any other shares thereof and is not subject to any prior interest therein" (R. 11). The sole basis upon which subordination could be found here would be that since Prudence guaranteed the securities, the debtor-creditor relationship existing between the company and the certificate holders creates a "special equity" which justifies a preference in favor of these certificate holders as against the remaining creditors of the insolvent guarantor. *In re Title & Mortgage Guaranty Company of Sullivan County, supra.*

If the rule adopted by the New York Court were applied solely in a case where the guarantor was itself solvent, there could be no reasonable objection to its determination. Avoidance of circuity of action could properly be a basis for such a rule. However, upon the insolvency of the guarantor and the coming into existence of rights on the part of its creditors to share in its assets, avoidance of circuity

of action no longer represents a tenable ground for a determination that certificates which it has repurchased and which constitute a part of the assets of its estate shall be subordinated in time of payment to the claims of certain certificate holders who are also included in the class of general creditors of the bankrupt guarantor.

The distinction existing between the case arising where the guarantor is solvent and where it is insolvent was carefully analyzed in *Kelly* v. *Middlesex Title Guarantee and Trust Company*, 115 N. J. Eq. 592, 171 Atl. 823 (Chancery), affirmed on this opinion by the New Jersey Court of Errors and Appeals in 116 N. J. Eq. 574, 174 Atl. 706. There, in holding that the participation certificates held by the insolvent guarantor were entitled to parity with other certificate holders, the court said, 115 N. J. Eq. at pp. 599, 600, 171 Atl. at p. 827:

> "The argument—and the conclusion by many authorities—that where the mortgagee gives to his assignee his guarantee of payment he should not be allowed to share *pro rata* in the proceeds of the security to the detriment of his assignee, has its sole logical basis (in the absence of any provision, agreement or representation between the parties in that behalf) in the theory of avoidance of circuity of action. As holders of the security they stand on an equal footing; each is entitled to his share of the proceeds of the security. If the assignee's share is not sufficient to pay him in full, the assignor is bound by his guaranty to pay him the deficiency. Giving the assignee a preferred interest in the proceeds in such a case simply enforces the performance of the guaranty; it saves the assignee the delay, trouble and cost of a separate suit to enforce the guaranty and marks no inequity to the guarantor or anyone else—*if* there is no other person having an interest in the security.
>
> "In the instant case, however, there *are* other persons having an interest in the security—to wit, the general creditors of the insolvent assignor, represented by the commissioner as trustee. The issue is not between the assignees (participation certificate holders) and the assignor (Middlesex Company or its stockholders). It is between the assignees on the one side

and the general creditors on the other. It is solely between successive assignees—for the trustee for the general creditors stands not in the position of the assignor, but in the position of an assignee of the unsold portion of the mortgage. The rights and interests of *all* general creditors in this unsold portion of the mortgage (and in all the other assets of the Middlesex Company) are equal (proportionately to their claims). The claim of the assignees on the guaranty is a general, unsecured claim. To grant to them any greater right or interest in the bond and mortgage than that which was specifically assigned to them as security would be giving them security for an unsecured claim, and would be giving them, as such unsecured creditors, an unlawful and inequitable preference over the other unsecured creditors."

The New York Court of Appeals has rejected avoidance of circuity of action as the basis for its rule, recognizing the fact that such a basis is inadequate to justify preferential treatment to a certain few creditors where the guarantor is insolvent. Although nominally describing its rule as being one based on "the intention of the parties, either as actually expressed, or as derived from the natural equity of the situation" (*Matter of Title and Mortgage Guaranty Company, supra,* 275 N. Y. at pp. 354, 355, 9 N. E. (2d) at p. 960), the clearest statement of the actual basis appears in *Pink* v. *Thomas, supra,* 282 N. Y. at pp. 12, 13, 24 N. E. (2d) at p. 725:

"• • • but if a mortgage company guarantees payment of certificates which it sells to third parties it is not entitled to share in the proceeds received from the sale of collateral until the third-party certificate holders are paid in full unless the certificates sold clearly provide that it retains such right (*Matter of Title & Mortgage Guaranty Company of Sullivan County,* 275 N. Y. 347), the underlying principle being that a mortgage company which sells participating certificates in a mortgage and itself guarantees them is in the position of a debtor, *and the equitable rule existing between debtors and creditors applies.* On default and absence of sufficient funds to pay certificate holders other than

itself in full it cannot share in the assets available until the certificate holders are paid in full. That is the law, and it is right. Having guaranteed the payment of the certificates it would be *highly inequitable* to permit it to step in and divert part of the security available to pay such certificate holders whom it had expressly guaranteed should be paid. No one in this case questions that principle.

"It should take very clear and unambiguous language in the certificates to overcome that rule and substitute a holding that in spite of its guarantee of payment it should be permitted to share in the available assets even though the certificates which it had guaranteed should be paid remain unpaid. *Such an inequitable result could be accomplished if the language used was so clear and unmistakable that the courts would be compelled to give effect to the intent of the parties as expressed in the writing. Otherwise the equitable rule should prevail.*" (Italics supplied.)

No portion of the language quoted above deals with intention of the parties as requiring subordination. The rule established speaks in terms of distribution between two creditors of an insolvent, one of whom holds claims against the other relating to the debt due from the insolvent. In determining their respective rights to share in the inadequate proceeds of the insolvent estate, the court has held that in its view the debtor-creditor relationship existing between the two creditors creates a special equity which requires that the guaranty creditor's participation be preferred until the guaranty claim is fully paid. That preference in favor of the guaranty creditor is justified by the court as an equitable rule of distribution to be applied under circumstances where the inadequate primary security is security not alone for the primary obligation but for the guaranty as well. (1941) 51 Yale L. J. 315, 317, 318; (1941) 51 Harv. L. Rev. 283, 284.

In discussing the basis of the New York rule, Judge Frank, dissenting below, said, 122 F. (2d) at page 509:

"Reference is also made to 'the implied or actual intent of the parties'; *Pink* v. *Thomas*, 282 N. Y. 10,

> 15, 24 N. E. 2d 724, 726; *Granger* v. *Crouch*, 86 N. Y. 494; 'implied' is significantly differentiated from 'actual' intent and thus means intent 'implied in law', i. e., not intent at all. And the same is true of the locution in some of the above cases as to a 'presumption of intent' as distinguished from the 'actual intent'."

Referring to the above quoted passage from *Pink* v. *Thomas*, which describes the New York rule as an "equitable rule", Judge Frank said further, 122 F. (2d) at page 509:

> "That is not the verbiage which the New York court would employ if it were determining that the parties had an actual intention, expressed in their contract, to create a preference; but it is verbiage appropriate in spelling out a rule of insolvency administration. And my brother judges concede that *Erie R. Co.* v. *Tompkins* does not require us to adopt such a rule."

Such a determination of equitable considerations, however, must be considered in the light of state insolvency statutes, which provide that whether or not the mortgage or underlying property constitute part of the assets of the insolvent guarantor, the certificate holder is deemed a secured creditor and may file a claim only for the difference between its guaranty obligation and the value of the mortgage. (New York Insurance Law, §544, subd. 6.) *Matter of New York and Mortgage Company*, 277 N. Y. 66, 13 N. E. [2d] 41). In reaching its conclusion that such holders were secured creditors under the state statute, the New York court contrasted the wording of the state statute with the provisions of the Bankruptcy Act, recognizing the contrary rule under the latter statute as stated by this Court in *Ivanhoe Bldg. & Loan Ass'n* v. *Orr*, 295 U. S. 243, 55 S. Ct. 685, 79 L. Ed. 419. Thus in *Matter of New York Title and Mortgage Company*, 160 Misc. 67, 289 N. Y. S. 771, reversed on other grounds, 277 N. Y. 66, 13 N. E. (2d) 41, *supra*, the court, in defining the phrase "Secured Creditor" under the New York statute, said (160 Misc. at p. 79, 289 N. Y. S. at p. 785):

"The definition of 'secured creditor' found in the Bankruptcy Act has not been carried over into the Insurance Law of this State."

Whatever equity may exist in cases arising under the New York insolvency statutes, where upon subordination, the certificate holder's claim on the guaranty is reduced not alone by the value of his participating interest in the mortgage but by the value of the guarantor's interest as well, such equity disappears in the bankruptcy court. In the latter court, under the *Ivanhoe* case, *supra,* there is no deduction from the claim, whether the guarantor's interest is deemed on a parity with, or subordinate to, the other participants. The effect of subordination under the New York insolvency laws increases the remaining guaranty creditors' participation in a partially diminished estate, whereas in bankruptcy, such subordination results in the diminution of the estate without any variation in the claims against it. The partial compensation granted to other creditors under the New York law for the preference granted the particular certificate holders, finds no counterpart under the Bankruptcy Act. Adoption, by the bankruptcy court, of the state rule of distribution results in the preference in favor of the single group of creditors, adding to the security for their claims and diminishing the estate, but leaves their participation in the remaining assets of the insolvent guarantor unaffected.

To establish such a rule of distribution as being based upon "special" or "natural" equities is to neglect entirely the rights of other guaranty creditors, holding similar guaranty claims, and constitutes a grant of a special status to a few solely by reason of the fortuitous acquisition by the guarantor of certificates in the issue in which such few are interested. Had the cash or other assets used by the guarantor to purchase these certificates remained in the general estate, such creditors would be entitled only to their pro rata share. Where such assets were exchanged for certificates, "Whatever value they [the certificates] have should be regarded as a substitute for such of the general

assets as was used to purchase them" (*Matter of New York Title & Mortgage Co.*, 253 App. Div. 308, 310, aff'd 278 N. Y. 488, 15 N. E. [2d] 430), and no greater benefits should be conferred upon the particular creditors solely by reason of such substitution.

Nothing decided by this Court in *Erie R. Co.* v. *Tompkins, supra*, requires the federal bankruptcy court to adopt the New York rule directing the preferential treatment to be accorded to particular unsecured creditors. If the determination by the New York courts constitutes a rule of administration of insolvent estates, it may not properly be transformed into a rule of interpretation merely because it is stated in such terms by the state court and therefore become binding on the federal court. In *Jennings, Receiver* v. *United States Fidelity & Guarantee Co.*, 294 U. S. 216, 55 S. Ct. 394, 79 L. Ed. 869, 99 A. L. R. 1248, Mr. Justice Cardozo in reading a state statute which created a trust in favor of certain groups of creditors upon the insolvency of a bank, said (294 U. S. at p. 226):

> "A trust so created, to arise upon insolvency, is a preference under another name. As applied to a national bank, the preference is plainly inconsistent with the system of equal distribution established by the federal law. R. S. §5236; 12 U. S. C. §194; *Davis* v. *Elmira Savings Bank*, 161 U. S. 275, 283, 284; *Easton* v. *Iowa*, 188 U. S. 220, 229; *Cook County National Bank* v. *United States*, 107 U. S. 445; *Lewis* v. *Fidelity & Deposit Co. of Maryland, supra* (292 U. S. 449). The power of the nation within the field of its legitimate exercise overrides in case of conflict the power of the states."

The legality of a preference arising through state judicial construction is determined not by the local law creating it but by provisions of the federal statute under which it is being enforced. The issue is one for federal determination and is "not influenced by consideration of local law." *Yonkers* v. *Downey, receiver*, 309 U. S. 590, 597, 60 S. Ct. 796, 84 L. Ed. 964.

So, too, where under Illinois decisions an assignment of future wages was held to create a lien which survived a bankruptcy discharge, this Court rejected the state decisions as being "destructive of the purpose and spirit of the bankruptcy act" and enjoined the prosecution of an Illinois state court action to enforce such a lien after the wage earner's discharge in bankruptcy. *Local Loan Co.* v. *Hunt*, 292 U. S. 234, 54 S. Ct. 695, 78 L. Ed. 1230.

The majority of the court below recognized the requirement of the Bankruptcy Act for pro rata distribution and the applicable law was stated by Judge Clark in his opinion at 122 F. (2d) at page 505, where he said:

> "If, however, the matter is one of insolvent liquidation only, we have a different situation. It is a necessary implication of the requirement of a plan of reorganization that 'it is fair and equitable and does not discriminate unfairly in favor of any class of creditors,' Bankruptcy Act, former §77B(f)1, as it is a corollary of the strict priorities rule of *Case* v. *Los Angeles Lumber Products Co.*, 308 U. S. 106, 60 S. Ct. 1, that a plan may not discriminate between different members of the same class of creditors or classify creditors arbitrarily, without due regard to their economic status as defined in their respective claims. See *Southern Pacific Co.* v. *Bogert*, 250 U. S. 483, 492, 39 S. Ct. 533, 63 L. Ed. 1099; 49 Yale L. J. 881, 882; 2 Gerdes, Corporate Reorganizations, 1682; Finletter, Bankruptcy Reorganization, 465. Similarly, Bankruptcy Act, §65a, requires, in liquidation, the distribution of 'dividends of an equal per centum' 'on all allowed claims, except such as have priority or are secured.' *Moore* v. *Bay*, 284 U. S. 4, 52 S. Ct. 3, 76 L. Ed. 133, 76 A. L. R. 1198; *Globe Bank & Trust Co.* v. *Martin*, 236 U. S. 288, 305, 35 S. Ct. 377, 59 L. Ed. 583; *Sampsell* v. *Imperial Paper & Color Corp.*, 61 S. Ct. 904, 907. The only departures made from the ordinary rule of equality are based on some very definite equity, such as fraud, *Pepper* v. *Litton*, 308 U. S. 295, 60 S. Ct. 238, 84 L. Ed. 281, mismanagement of the debtor by a parent corporation, *Taylor* v. *Standard Gas & Electric Co.*, 306 U. S. 307, 59 S. Ct. 543, 83 L. Ed. 669, or concealment of a claim to the prejudice of another creditor,

In re Bowman Hardware & Electric Co., 7 Cir., 67 F. 2d 792. "In the absence of such an equity, subordination is not a function of the bankruptcy court. *Crowder* v. *Allen-West Commission Co.*, 8 Cir., 213 F. 177, 184; *Sampsell* v. *Imperial Paper & Color Corp., supra; cf. Moise* v. *Scheibel*, 8 Cir., 245 F. 546."

The respondent here has rested upon proof of the guaranty and default upon its obligations and the New York decisions, as his sole foundation for the claim to priority (R. 3-9). The fact of insolvency of the guarantor, and the rights of other creditors of the bankrupt, the protection of which is the proper function of the bankruptcy court, have not been considered either by respondent or the majority of the Circuit Court of Appeals. The bankruptcy court may not relieve the priority claimant of the burden of showing his right to such priority or preference. *Sampsell* v. *Imperial Paper & Color Corporation*, 313 U. S. 215, 61 S. Ct. 904, 85 L. Ed. 1293. The determination that such priority right exists may not rest upon decisions of the local courts but should be determined in accordance with applicable bankruptcy provisions. *In re Blue Bird Appliance Co.*, (C. C. A. 8th) 292 Fed. 127; *Rapple* v. *Dutton*, (C. C. A. 9th) 226 Fed. 430; *John Deere Plow Co.* v. *McDavid*, (C. C. A. 8th) 137 Fed. 802.

POINT II

Where rules of insolvency distribution prescribed by the Bankruptcy Act and state decisions are in conflict, the Bankruptcy Act is paramount and must be applied by the bankruptcy court.

The majority of the Circuit Court of Appeals believed that even if the bankruptcy court is not bound to follow the rule established by the New York decisions, the rule should be applied, since, "Creditors of different New York mortgage-guaranty companies ought to receive similar treatment, without regard to the tribunal in which liquida-

tion occurs, for certainly their investments were made under substantially identical conditions". 122 F. (2d) at p. 507.

No justification is given by the Court for the adoption of this doctrine in the instant case. Certainly no peculiar factors are present here which are absent in any other normal business transactions. It has never been held by this Court or any other federal court that in any other type of debtor-creditor relationship, the federal bankruptcy court may follow state decisions determining distributive rights under state insolvency law, when such decisions conflict with the provisions of the Bankruptcy Act, and that any principle of uniformity requires such a result.

On the contrary, it has been held that where any conflict exists, the Bankruptcy Act is paramount, and state insolvency laws are suspended. *Sturges* v. *Crowninshield*, 4 Wheat. 122, 4 L. Ed. 529; *International Shoe Co.* v. *Pinkus*, 278 U. S. 261, 49 S. Ct. 108, 73 L. Ed. 318. A congressional statute which directed the federal bankruptcy courts to apply state rules of insolvency distribution where a conflict with the Bankruptcy Act existed would violate the Constitutional direction to "establish * * * uniform Laws on the subject of Bankruptcies throughout the United States." (Constitution, Art. I, §8.) For the federal court to disregard general bankruptcy precedents in a particular case simply because the state court has previously passed upon the effect of its own insolvency laws on the specific transaction, does no less violation to the constitutional mandate for uniformity.

In (1941) 51 Yale L. J. 315, 321, the author, discussing the instant case said:

> "As pointed out in Judge Frank's dissent, uniformity of bankruptcy administration throughout the United States is, by express constitutional provision, made paramount to federal conformity with the rule of a particular state. This constitutional mandate would seem to preclude a federal court from following state insolvency law in order to promote local uniformity, especially where the bankruptcy rule is directly contrary, as in the instant case."

It is submitted that in the instant case, the majority's conclusion is based upon a failure to appreciate the statutory nature of the state court proceedings, and the varying provisions for the administration of insolvents' estates under the state insolvency and the national bankruptcy laws. No cogent reason appears why the federal court should assume the desirability of uniformity with state rules of distribution in cases where the claims in the state and federal insolvency proceedings are filed on directly opposed theories. As has been demonstrated *supra*, under Point I, the New York Insurance Law, §544, subd. 6, as construed by the New York court in *Matter of New York Title and Mortgage Company*, 160 Misc. 67, 289 N. Y. S. 771, *supra*, directs the filing of guaranty claims as secured claims, even though the security for the debt is not the property of the insolvent. The *Ivanhoe* case, *supra*, establishes, as the bankruptcy rule, that a creditor holding the same type of claim files as an unsecured creditor in a bankruptcy proceeding. The conclusion of the majority of the Circuit Court that the distributive rights of such creditors shall remain identical in the state insolvency and the federal bankruptcy proceedings, disregards the basic distinction existing in the Bankruptcy Act between the participation accorded to secured and unsecured creditors. As secured creditors of the bankrupt guarantor, they would be required to deduct the value of the security from their guaranty claim, [Bankruptcy Act, §57h (11 U. S. C. A., §93h)], and to that extent their participation in the insolvent estate would be diminished, for the benefit of the remaining general creditors. In the absence of the requirement that their claims be reduced under the Bankruptcy Act, the guaranty holders participate in the insolvent's estate on a parity with other claimants for the full amount of their claims.

Under the circumstances, to fully carry out the majority's decision that similar treatment should be accorded to guaranty creditors whether the insolvent is liquidated under the New York Insurance Law or the Bankruptcy Act, requires more than the result in the instant case. To adequately

carry out that decision, the Bankruptcy Act definition of "secured creditor" must be abandoned in favor of the state definition found in the New York Insurance Law. Failing that, the desire for uniformity expressed by the majority becomes meaningless and inadequate as the basis of decision. If "similar treatment" is to be accorded the guaranty creditor, the rights of other creditors must be considered. Recognition of such rights requires that the guaranty creditor's claims must be established in bankruptcy on the same basis as they are allowed in the New York insolvency proceedings. That, the bankruptcy court may not do in view of the specific terms of the Bankruptcy Act. *Ivanhoe Bldg. & Loan Assn.* v. *Orr, supra.*

In discussing the majority's conclusion as to the desirability of uniformity, Judge Frank, dissenting below, said, 122 F. (2d) at p. 510:

> "Related considerations are pertinent with respect to the suggestion in the majority opinion that, even if we are free to ignore the New York rule, we should not do so, since, thereby, persons in similar circumstances, *vis a vis* an insolvent guarantor, will be treated differently by state and federal tribunals. Such an argument is self-defeating: No doubt uniformity between state and federal courts is desirable; but so is nationwide uniformity of bankruptcy administration; if the majority opinion assists in establishing the first of these, it helps to destroy the second. Where a paramount public policy does not demand it, I can see no reason for our going out of our way to transplant, from the state to the federal courts, a doctrine which is so curiously lacking in logic and fairness as the New York rule of automatic subordination."

POINT III

Upon equitable grounds petitioner's certificates are entitled to parity of distribution.

In deciding that equitable considerations required a determination that petitioner's certificates are to be sub-

ordinate in time of payment to certificates held by others, the majority of the Circuit Court of Appeals erroneously assumed that there was here involved a consideration of mutual claims between inter-related companies which therefore justified the conclusion that their customers should receive prior payment, and further erroneously concluded that petitioner took with full notice of the situation from the reorganization proceedings generally in view of the explicit reservation of the question and the confirmation of the reorganization of the Zo-Gale certificate issue (R. 136) (122 F. [2d] at 507).

The original relationship between Prudence (the guarantor), Prudence-Bonds Corporation (the mortgagee) and Amalgamated Properties, Inc. (the debtor), to which the majority referred, has been extinguished. Prudence and Prudence-Bonds Corporation, judicially found to be insolvent, have been reorganized separately for the sole benefit of their respective creditors (R. 44, 97); *In re Prudence-Bonds Corporation,* (C. C. A. 2d) 122 F. (2d) 258, 261. The creditors of Prudence-Bonds Corporation who are now its sole owners are also creditors of Prudence (R. 100, 101). Amalgamated Properties, Inc. is now owned by Reconstruction Finance Corporation, also a Prudence creditor, which accepted the Amalgamated stock as part of the security for a loan to Prudence before the date of the acquisition by Prudence of the Zo-Gale certificates here in question. *In re The Prudence Company, Inc.,* (C. C. A. 2d) 90 F. (2d) 587.

The issue here therefore remains one solely between creditors of Prudence and not between inter-related corporate entities. The rights of creditors have intervened and to use the majority's own words, "as a matter of practical equity" *all* of such creditors should receive similar treatment without priority or preference in favor of one as against the others. Although the rule established by the New York court and adopted by the majority of the Circuit Court of Appeals may properly be applied where the guarantor is solvent, "*it becomes a totally different rule*

when, as here, the guarantor itself is a bankrupt, then the problem which confronts the federal courts is one of equitable distribution, under the Bankruptcy Act of the insufficient proceeds of a guaranteed obligation among all the guarantor's creditors, including the assignees of a portion of the guaranteed obligation." (Judge Frank's opinion, 122 F. [2d] at p. 508.)

The assumption that respondent representing all of the Prudence creditors took with full notice of the situation because of the reservation in the Zo-Gale reorganization proceeding fails to recognize the status of petitioner as such creditors' representative. The adoption of the corporate entity, Prudence Realization Corporation, in order to permit the liquidation of the bankrupt's assets for the benefit of all creditors was an expedient which did not alter the existing rights of the individual creditors by whom petitioner's assets are owned. As Judge Frank said in his dissenting opinion in referring to the effect of the reservation of the Zo-Gale proceedings:

> "that sort of notice is inefficacious to create equities, although it would preserve them if they already existed; Appellant represents the interests of Prudence's creditors; it was created long after they became creditors; they became creditors without any such notice; the notice to which the majority refers served merely to keep open for future decision the question, first raised in the Zo-Gale proceedings, of whether or not, because of facts previously occurring (including no such notice), there should be a subordination." (122 F. [2d] p. 508.)

There appear to be no equitable considerations present in the instant case which compel the abandonment of the bankruptcy rule that "equality is equity". On the contrary:

> "Several elements of the immediate situation favor according equality of participation to the certificates held by the guaranteeing company. It is only the circumstance of that company's choice to invest in one of its own issues, rather than to distribute the entire issue to the public, which leads to its subordination in

the principal case. Furthermore, the public holders of other issues of mortgage participation certificates and miscellaneous other creditors, in making their investment, relied upon the assets of the guaranteeing company, a part of which consisted of retained or reacquired shares. From the point of view of these other general creditors of the guarantor, the participating certificates held by the company would be considered substituted value for general assets expended in their acquisition, a consideration rejected by the decision in the instant case." (1941) 51 Yale L. J. 315, 321, discussing the instant case.

POINT IV

The plan of reorganization for the insolvent guarantor did not separately classify Zo-Gale guaranty creditors and bars respondent's claim for priority.

The order entered in the District Court upon the granting of respondent's motion in the instant case provides that petitioner shall not be entitled to receive any distribution of principal or interest until "the third party certificate holders have been paid the full principal and interest guaranteed under the certificates held by such third party certificate holders" (R. 126).

The asserted right to priority in payment in favor of other certificate holders therefore is based upon, and measured by, the *guaranty* obligation rather than the amount of principal and interest due on the *mortgage*, and constitutes another method of enforcing collection of the guaranty obligation. *Kelly* v. *Middlesex Title Guarantee and Trust Company, supra.* Such judicially granted right to enforcement of collection is not predicated upon a determination that the other certificate holders have a prior lien in the mortgage as against the guarantor or its successor, the creditors of Prudence Realization Corporation. On the contrary, it has been held by the New York State court that no such priority of *lien* exists. *In the Matter of the*

New York Title and Mortgage Company (*381-383 Park Avenue*), 163 Misc. 318, 296 N. Y. S. 644, aff'd without opinion 254 N. Y. App. Div. 722, 4 N. Y. S. (2d) 1004. There, in refusing to permit the trustee of the certificated mortgage to wipe out the liquidator's certificated interest in the mortgage represented by subordinated certificates, the court held that the trustee of the mortgage was a trustee for *all* certificate holders, and though the guarantor's interest in the proceeds of the certificated mortgage was subordinate in time of payment to that of other holders, the interest of the guarantor in the mortgage itself was coordinate in lien and could not be cut off by foreclosure.

In the instant case, Prudence was reorganized under Section 77B of the Bankruptcy Act and all claims based upon its guaranties were filed in the proceeding for its reorganization (R. 19). Included were claims filed by or on behalf of the Zo-Gale certificate holders (R. 19). All such claims were filed as unsecured claims, no reservation being made in the proof of claim with respect to any security or claim for security with respect to the guaranty obligation. The claims were allowed in the full amount of principal and interest at the guaranteed rate (R. 101). In accordance with the provisions of Section 77B, the plan of reorganization adjusted the participating interest of all creditors in the Prudence estate. Such adjustment constitutes a discharge of any obligations on the guaranty in the future except as provided by the plan. *City Bank Farmers Trust Co.* v. *Irving Trust Company*, 299 U. S. 433, 57 S. Ct. 292, 81 L. Ed. 324; *Black* v. *Richfield Oil Corporation*, (D. C. S. D. Cal.) 41 F. Supp. 988.

Paragraph 19 of the order confirming the Prudence plan of reorganization provides that the claims of guaranty holders "shall be payable without interest only as provided in Article IV of the Amended Plan and only to the extent that the New Company's assets shall be sufficient to pay them * * *." The same paragraph provides that there are no claims or interests against the estate having priority except claims for amounts due as taxes to the United States

of America, the State of New York and reorganization expenses (R. 106, 107). The plan itself does not separately classify the Zo-Gale certificate holders but deems them included within the general category of guaranty creditors (R. 70, 71). Paragraph 24 of the same order of confirmation provides that the provisions of the plan and of the order of confirmation shall be binding upon all creditors secured or unsecured (R. 110).

It is submitted from the foregoing that the Prudence plan adjusted all claims against the insolvent guarantor, and constitutes a final determination of the rights of any of the creditors to participate in the assets of that corporation which were turned over to petitioner pursuant to the plan. The failure of the Zo-Gale certificate holders to secure any special rights in these assets or any part of them in that plan constitutes a bar to any further attempts to make additional recoveries upon the guaranty obligation. The Zo-Gale reorganization proceeding could not effectively grant any additional rights to the Zo-Gale certificate holders with respect to the guaranty obligation. The proper forum for adjustment with respect to that obligation was The Prudence Company, Inc. reorganization proceeding. *In re Diversey Building Corp.*, (C. C. A. 7th) 86 F. (2d) 456; *In re Nine North Church Street, Inc.*, (C. C. A. 2d) 82 F. (2d) 186.

Recognizing the fact that the Zo-Gale certificate holders in asserting their right to priority as against petitioner in the distribution of the proceeds of the Zo-Gale mortgage are not asserting a lien claim, no justification appears for the additional distributions to be directed to be made to them on account of the guaranty obligation. If parity of participation is accorded petitioner, the proceeds of the participation certificates held by petitioner in the Zo-Gale mortgage will become part of the general Prudence estate and will be distributed pro rata among all of its creditors including the Zo-Gale guaranty creditors. However, a determination that petitioner's participation in the Zo-Gale mortgage is subordinate to that of the Zo-Gale holders

grants to that special group of creditors a right to divert such assets from the general Prudence estate for their sole benefit and permits them further to participate without change in status in the distribution of the remaining assets of the estate. The respective rights of the various guaranty claimants to share in the Prudence assets have been determined in the Prudence plan, and the order confirming the plan is *res adjudicata* with respect to any later effort to enforce additional rights. *In Re Lyman Richey Sand & Gravel Co.*, (D. C., D. Neb.) 42 F. Supp. 158, 160, 161. That final adjudication may not be collaterally attacked. *Stoll* v. *Gottlieb*, 305 U. S. 165, 59 S. Ct. 134, 83 L. Ed. 104.

It is a necessary corollary of the rule requiring the division of creditors into classes according to the economic status of their claims that such classification must take place in the bankruptcy or insolvency forum. *Case* v. *Los Angeles Lumber Products Co.*, 308 U. S. 106, 60 S. Ct. 1, 84 L. Ed. 110; *Northern Pacific Railway* v. *Boyd*, 228 U. S. 482, 33 S. Ct. 554, 57 L. Ed. 931; (1941) 51 Yale L. J. 315, 320, 321. Without the requirement that all factors necessary for the consideration of the issue of classification be submitted for determination in that forum, the basis of the rule becomes unsound. If the creditor may reserve additional rights against particular assets of the bankrupt despite his failure to urge such rights in the bankruptcy court, the latter's determination of classification rests upon an inadequate basis to the prejudice of other creditors.

In the Prudence bankruptcy proceeding, the Zo-Gale certificate holders proved their claims as unsecured creditors, were so classified and under the Prudence plan are to receive parity of treatment with all other unsecured creditors. No preferential treatment in their favor was provided in the plan and no claim for any preference was asserted in the Prudence proceeding by the Zo-Gale creditors. The bankruptcy court's determination that their claim should receive equal treatment with other guaranty claims as having the same economic status was supported

by the similarity in the various guaranty obligations and the absence of any characteristics which distinguished the Zo-Gale claims from any other guaranteed claims. Had the additional right to priority with respect to the proceeds of a portion of the assets of the insolvent Prudence estate been asserted in the Prudence proceeding and been upheld by the court, the remaining creditors would have been entitled to separate classification with the attendant right to reject a plan which recognized the priority claim of the Zo-Gale creditors but failed to take such priority into account in providing for pro rata distribution of the remaining assets among all creditors, including the Zo-Gale certificate holders. In effect, the Zo-Gale certificate holders, after confirmation of the Prudence plan, are seeking to file a further claim against the assets of the insolvent guarantor's estate which would require a modification of that plan. That the bankruptcy court will not permit in the Prudence proceeding (*In re Diana Shoe Corp.* [C. C. A. 2d], 80 F. [2d] 92), nor may such modification be effected in the *Zo-Gale* proceeding, as is here being attempted. *In re Lyman Richey Sand & Gravel Co., supra; cf. Stoll* v. *Gottlieb, supra.*

POINT V

The uncertificated interest in the mortgage held by petitioner is entitled to parity.

Even if the Circuit Court were correct in applying the New York decisions to the instant case, it should have held that the uncertificated share in the Zo-Gale mortgage now held by petitioner was entitled to parity. However, the court deemed the uncertificated portion of the Zo-Gale mortgage now held by petitioner as having the same status as the actually issued certificates of participation, and therefore held them to be subordinate to the outstanding certificates. The court assumed that since Prudence-Bonds Corporation did not give any money value for the Zo-Gale

bond and mortgage when it received the original assignment from Prudence, all portions of the mortgage which were not certificated and not sold were actually the property of Prudence at all times, and therefore determined the question of parity without regard for the distinction existing between the certificated and the uncertificated portions of the mortgage (122 F. [2d] at p. 507).

The court overlooked the circumstances under which the Prudence Trustees acquired the uncertificated portion of the mortgage from the Trustees of Prudence-Bonds Corporation. To dispose of certain claims of the Prudence estate against Prudence-Bonds Corporation, a compromise was entered into with the trustees of Prudence-Bonds Corporation. As part of the consideration for such compromise, the uncertificated portion of the Zo-Gale mortgage as well as similar interests in other certificate issues were transferred to the Prudence Trustees, *subject, however, to general claims of general creditors of Prudence Bonds Corporation* (R. 20). The requirement that these portions of the mortgages be acquired subject to the rights of general creditors of Prudence-Bonds Corporation recognizes their status as corporate assets of Prudence-Bonds Corporation and the fact of its insolvency. It is to be noted that Prudence-Bonds Corporation had outstanding approximately $56,000,000 of personal obligations based upon its issuance of bonds upon which it was primary obligor (R. 38).

Upon the insolvency of Prudence-Bonds Corporation, the rights of these creditors to any of its corporate assets became clear and determined. The assignment of the Zo-Gale mortgage by Prudence to Prudence-Bonds Corporation, absolute by its terms, containing no defeasance provisions, might properly be considered as part of the Prudence-Bonds estate by these bondholders, and constitutes an estoppel against the possible Prudence claim of ownership. *In re The Prudence Company, Inc.*, (C. C. A. 2d) 82 F. (2d) 755, cert. den. 298 U. S. 685, 56 S. Ct. 957, 80 L. Ed. 1405.

Respondent in asserting in the District Court and the Circuit Court of Appeals that the uncertificated portion should be treated on the same basis as the actually issued certificates held by petitioner did so in recognition of the fact that even under the decisions of the New York courts such uncertificated portion in the hands of Prudence-Bonds Corporation would be entitled to parity of treatment with the other holders of certificates. *Pink* v. *Thomas; Matter of Title Mortgage Guaranty Co.; Title Guaranty and Trust Co.* v. *Mortgage Commission*, all *supra*. Under these decisions, Prudence-Bonds Corporation, bearing no debtor-creditor relationship to the other holders of certificates, would be entitled to parity.

The precise issue presented in this case with respect to the uncertificated portion of the mortgage has been decided by the New York court in *Matter of Southeast Corner of National Boulevard and West Broadway, Long Beach (Bond and Mortgage Guarantee Company; Guaranty No. 170794)*, Supreme Court, Kings County, reported in the New York Law Journal January 31, 1940. There a trustee of a certificated mortgage guaranteed by the Bond and Mortgage Guarantee Company then in liquidation made a motion for an order adjudicating the certificates held by the Liquidator of the Guarantee Company to be subordinate to other certificates in the series. Mr. Justice Brower determined that the certificates acquired by the Superintendent of Insurance of the State of New York as Rehabilitator from Title Guarantee and Trust Company, which had issued and sold the certificates guaranteed by Bond and Mortgage Guarantee Company as part of a business transaction, were entitled to parity with all other certificates in the series. In making this determination Mr. Justice Brower said:

> "This share or interest when held by Title Guarantee & Trust Company was on a parity with and equal to the shares represented by certificates held by other holders (Title Guarantee and Trust Co. v. Mortgage Commission, 273 N. Y. 415). It was not acquired in

> partial performance of the contract of guaranty. It was never the property of the Guarantee Company prior to the entry of the order of rehabilitation. The question of parity should be determined, therefore, as of the time this interest was owned by Title Guarantee and Trust Company (cf. Matter of Lawyers Mortgage Co. (6801 Bay Parkway), 15 N. Y. Supp. 2nd, 239). It was then on a parity and it now still is on a parity."

The decision above referred to and quoted has direct application to the question here in issue. The Superintendent of Insurance held a position identical to that of the Prudence Trustees. The transaction by which the uncertificated interest was acquired by the Prudence Trustees, as was true in the State Court decision, took place after the institution of the reorganization proceeding. Prudence-Bonds Corporation, like Title Guarantee and Trust Company, had merely issued the certificates but had not guaranteed payment of principal or interest, nor had it become the primary obligor. All portions of the decision above quoted refer specifically to the state of facts present in the instant case, since the transaction by which Prudence acquired this interest in the mortgage was simply one of the many steps in the reorganization of Prudence. The position, therefore, taken by Prudence Realization Corporation that the acquisition of the uncertificated interest in the mortgage resulted in a purchase by the Prudence Trustees of the rights of Prudence-Bonds Corporation which would be entitled to parity is borne out in all detail by the applicable decisions of the State Court.

POINT VI

The decision of the Circuit Court of Appeals for the Second Circuit is erroneous in all respects and should be reversed.

Respectfully submitted,

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